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The Sanders-AOC Protection for Loan Sharks Act

Todd J. Zywicki

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Last month, Sen. Bernie Sanders and Rep. Alexandria Ocasio-Cortez debuted the Loan Shark Prevention Act, whose chief provision amounts to a national interest rate ceiling of 15%. In a video accompanying the announcement, Sanders invoked Hollywood's version of loan sharks to illustrate his point: "You've got all these guys in their three-piece suits who are now the new loan shark hoodlums that we used to see in the movies. You know, in the movies, they say, 'I'll break your kneecaps if you don't pay back.' Well, I don't know that they break kneecaps …"

Sanders's invocation of yesterday's leg-breakers is obviously intended to conjure the colorful figures of American imagination, from Don Corleone to Tony Soprano. But the terror that real loan sharks inflicted on immigrant and working-class families is not merely the stuff of Hollywood; it was a brutal reality for much of American history. And the ubiquity of loan sharks in American history is directly attributable to forerunners of the interest-rate ceilings proposed by Sanders and Ocasio-Cortez.

"Usury ceilings," as interest-rate price controls were traditionally labeled, began as a paternalistic effort to protect low-income and supposedly vulnerable consumers from exploitation by greedy bankers. Yet, as well-intentioned regulations so often do, usury ceilings backfired spectacularly, primarily harming those they were intended to help. And far from shutting down loan sharks, history shows that usury ceilings have been the primary catalyst for the loan sharks that have preyed on low-income and vulnerable Americans throughout history.

The advent of industrialization saw thousands of prewar immigrants and farmers flood into American cities in search of work. The challenges of city living created unprecedented demand for small-dollar, short-term loans. Yet making small loans to wage earners was an expensive business. First, it was risky — the same factors that necessitated borrowing in the first place (low wages, periodic unemployment, and unexpected expenses such as medical bills and home repairs) translated into high loss rates. Second, the costs of small loans is high relative to the amount borrowed —operating expenses such as rent, employee wages, and utilities are very similar regardless of whether the customer borrows $50, $500, or $5,000. In order to cover losses and those operating expenses, therefore, the effective interest rate on a small loan will have to be higher.

As a result, prohibitively low usury ceilings made it impossible for working families to borrow the money they needed from legitimate lenders. Illegal loan sharks filled the void, creating a reign of terror in American cities.

In New York, future Republican presidential candidate Thomas Dewey first came to fame through his 1935 bust of the city's loan shark racket. With 1,040% interest rates and brutal

means of enforcement — including, according to the front page of the New York Times, "Beatings and Death Threats" — the operation had netted the syndicate a cool $5 million. Former Federal Reserve Chairman Alan Greenspan referred to it as an era of "virtual serfdom" for urban families trying to make ends meet.

In response to the ubiquitous problem of loan sharks, consumer advocate groups led a nationwide crusade to loosen interest rate restrictions to permit legitimate lenders to compete with the loan sharks. The reform effort culminated in the drafting of the Uniform Small Loan Law, which proposed dramatic increases in state usury ceilings. Although the proposal to raise usury ceilings was controversial at first, by mid-century the loan shark problem had largely dissipated in states that adopted the law, replaced by personal finance companies and small-loan companies operating legally.

Yet the lull in regulation, and crime, would prove short-lived. Acting under the theory that excessive access to consumer credit by working families was a primary cause of the Great Depression, many states rolled back their liberalization of interest rate ceilings. The results were predictable — and devastating to America's working families. According to a Senate investigation, by 1968 loan sharking was the second largest revenue source of organized crime. That same year, Republican presidential candidate Richard Nixon pledged to appoint an attorney general that would "be an active belligerent against loan sharks and the numbers racketeers that rob the urban poor in our cities." A 1969 book by a former police officer estimated the size of the illegal loan shark industry to be $10 billion per year — the equivalent of $69 billion in today's dollars and about twice the size of the estimated $32 billion payday loan market (storefront and online combined) today in the United States.

Unfortunate borrowers were often lucky to get off with "only" a broken leg. In one 1978 criminal trial, prosecutors played a tape recording in which Louis "Blind Louie" Cavallaro of the Chicago syndicate threatened to "cut out the eyes and tongue of a man who owed him $18,000" and expressed his desire to wear the victim's teeth "around [his] neck." Threats involving the forcible amputation and public display of body parts usually kept private seem to have been especially popular. Usually threats, in connection with the loan shark's menacing physique and reputation for violence, were enough to ensure timely payment, but not always. One mob enforcer confessedthat when one borrower didn't pay up, he "clipped off" a portion of the borrower's ear and then explained that if "you pay me you can keep the rest of your ear." If not, he would take the remainder. "Then the next day I'll take your other ear. Then we'll start on your fingers." Still other delinquent customers were enlisted by the shark into criminal activity to pay off their debts.

Liberal politicians and consumer advocates were finally forced to admit that usury ceilings ended up hurting those they intended to help. In 1964, the New York state legislature opened an inquiry into the state's billion-dollar loan-sharking racket. Sen.-elect Robert F. Kennedy, in a statement filed with the committee, recommended "altering the state laws on usury so an insolvent person who needs money for legitimate purposes might borrow it at rates that were not exorbitant."

Kennedy's sentiment echoed the economic and sociological consensus of the time. A year before becoming the first American to win the Nobel Prize in Economics, Paul Samuelson had appeared before the Massachusetts legislature to testify that "[f]or 50 years" research demonstrated that "setting too low ceilings on small loan interest rates will result in drying up legitimate funds to the poor who need it most and will send them into the hands of the illegal loan sharks." He

continued, “History is replete with cases where loan sharks have lobbied in legislatures for unrealistic minimum rates, knowing such meaningless ceilings would permit them to charge much higher rates.” A decade later, a Cornell study prepared for the United States Department of Justice concluded, “[T]here can be little doubt that [usury laws], at least in part, have created a black market for credit dominated by organized crime.”

The high inflation rates of the 1970s tolled the intellectual death knell for restrictive interest rate ceilings and the Supreme Court’s 1978 decision in the *Marquette National Bank* case effectively deregulated credit card interest rates by holding that the applicable interest rate on a credit card would be the issuing bank’s state ceiling, not the consumer’s state. The results transformed the American economy: Between 1970 and 2000, the percentage of American households with general purpose credit cards rose from 15% to 70%. And loan sharking became the thing of movies, cable television programs — and now, ill-conceived legislative proposals.

Comparing today’s financial markets to Hollywood villains diminishes the real terror that loan sharks inflicted on generations of immigrant and working-class families and ignores the pivotal role of usury ceilings in creating the conditions for loan sharks to operate. The story of the relationship between usury ceilings and loan sharking is one that’s had numerous remakes and sequels. It always ended the same way — with desperate borrowers turning to illegal lenders to get money in a pinch. Congress can pass all the laws it wants, but it can’t repeal the law of supply and demand — or the law of unintended consequences.

Todd J. Zywicki is George Mason University Foundation Professor of Law at Antonin Scalia Law School, a senior fellow at the Cato Institute, and co-author of “Consumer Credit and the American Economy” (Oxford University Press, 2014).